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C O N F I D E N T I A L SECTION 01 OF 04 TEGUCIGALPA 000621

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TAGS: ECON EFIN KDEM HO
SUBJECT: TFH01: IMPACT OF COUP AND AID CUT-OFF ON HONDURAN
ECONOMY

REF: A. TEGUCIGALPA 586
¶B. TEGUCIGALPA 576
¶C. TEGUCIGALPA 542

Classified By: Ambassador Hugo Llorens for reasons 1.4(b & d)

¶1. (C) Summary: The expected reduction in international aid as a result of the June 28 coup will cause hardship for the de facto regime, but the Honduran economy should still be able to avoid collapse this year, barring an unexpected shock, such as a trade embargo or natural disaster. The economy was already weakening before the coup as a result of the global recession and questionable policy choices (ref C). It will likely continue to weaken in the second half of 2009, possibly exacerbating civil tensions. The full impact of the political crisis and diplomatic isolation will probably not be felt until later. End Summary.

¶2. (U) As a result of the June 28 forced removal and expulsion of President Manuel "Mel" Zelaya by the Honduran armed forces, the international community has suspended certain direct assistance to the GOH. This, on top of the global recession and recent policy choices, will likely have a significant negative impact on the economy. This message attempts to estimate the economic impact over the next six months of the political crisis and cut-off of international financial flows. It is based on the following assumptions:

-- Diplomatic isolation: Suspension from OAS and isolation from other international organizations will result in the cut off of most external aid;

-- Normal trade relations: no trade sanctions as a result of the coup, other than the cut-off of subsidized Venezuelan fuel, which we assume can be easily replaced although on commercial terms;

-- Continued political impasse: the de facto regime of Roberto Micheletti remains in power, with sporadic strikes and demonstrations but no major escalation of violence;

-- No outside military intervention.

¶3. (U) This baseline scenario could obviously be altered by any number of factors:

-- Trade sanctions: would have a severe impact, since Honduras exports about a third of its GDP to the U.S.

market alone;

-- Escalation of violence: Large-scale disturbances or violent insurrection over a period of months would severely disrupt the economy and further dampen the investment climate;

-- Capital flight: could quickly deplete international reserves, limiting the country's ability to service debt and pay for imports;

-- Natural disaster: Honduras is vulnerable to hurricanes and floods. Humanitarian aid would probably be available immediately after the disaster, but the possible lack of reconstruction assistance could impair recovery efforts.

Situation Facing de Facto Regime

¶4. (SBU) Ref C described the situation and outlook of the Honduran economy at the time of the June 28 coup. The de facto government inherited a difficult financial situation. Zelaya had not submitted a budget for 2009 and was apparently spending funds with few controls. Exports and remittances were declining, and growth had slowed dramatically over the previous 18 months. In 2009, without a budget and with Zelaya's team diverting funds to promote its constitutional reform initiative, fiscal discipline evaporated, leaving the de facto government with severely constrained public finances.

¶5. (SBU) The Zelaya government borrowed about USD 300 million domestically in 2008 to recapitalize the National Electric Company (ENEE) and to cover the fiscal deficit. In the first half of 2009 it borrowed a similar amount. In addition, the Zelaya Administration borrowed about USD 130 million from Venezuela that had not been included in its original borrowing plans. Even with the additional borrowing from Venezuela, the external debt is easily sustainable. Almost all of it is on very concessional terms. The internal debt situation is more worrisome. Although the stock of domestic debt is not large in relation to GDP, much of it will need to be refinanced over the next seven months (ref C).

Impact of Aid Cut-Off

¶6. (C) External budget support had already begun to wane under the Zelaya administration due, at least in part, to the lack of an agreement with the IMF and the fact that the other development banks were waiting for the new government to be elected. Such aid is likely to be further significantly reduced if not eliminated as long as the de facto regime remains in power (although at least some project aid will likely continue). The 2009 budget submitted to Congress July 15 calls for USD 560 million in external finance. In the absence of budget support from donors, the de facto government will need to look to the domestic market for most of this financing.

¶7. (U) The de facto government submitted a budget to Congress July 15 proposing a 10-percent reduction in spending and other austerity measures. The budget is to be financed by internal borrowing of 10 billion lempiras (USD 529 million) and external borrowing of 10.52 billion (USD 560 million). The Ministry of Finance plans to issue new domestic bonds under the authority of the 2009 budget once it is approved by Congress. Without access to external credits, however, it will likely need to borrow far more domestically than the USD 529 million contemplated in the budget.

¶8. (SBU) The financial system has about 27 billion lempiras (USD 1.43 billion) in excess liquidity due to the global

credit crunch (which has made them reluctant to loan) and policies of the Zelaya government. Banks have said they are willing to support the de facto government by buying more bonds, which are now being offered at more attractive rates than before. But the amount that will need to be borrowed to finance the 2009 budget would represent a significant increase in their holdings of government debt. The Central Bank may need to increase the level of reserves banks are required to hold in government bonds.

¶9. (SBU) Current expenditures, particularly for salaries, grew rapidly under Zelaya. To make ends meet, the de facto government will have to not only curtail spending growth but actually reduce outlays in absolute terms. That will probably require layoffs and/or salary freezes for public employees, which could exacerbate social tensions, especially among the unruly teachers unions.

¶10. (SBU) The political crisis will likely have little impact on the de facto government's ability to service the foreign debt. The debt-GDP ratio is low, thanks to USD 4 billion in debt forgiveness 2004-2007, terms of remaining debt are highly concessional, and the Central Bank has adequate reserves on hand. The exception would be if debt contracts include default clauses that allow acceleration (immediate demand for repayment) in the case of certain political events. Anecdotal evidence indicates that few if any of the contracts include such clauses.

¶11. (SBU) Public investment declined under Zelaya, and given the shortage of funds available to the de facto government, it will likely continue to suffer in the medium term. Unavailability of soft loans from foreign donors could further depress investment.

Capital Flows and Reserves

¶12. (SBU) Data are not yet available to gauge the impact of the coup on private capital flows. Some banks and business associations have said the business climate is better under the de facto government than under Zelaya, and investment may therefore increase. However, this might just be wishful thinking.

¶13. (U) Remittances from Hondurans living in the United States, which have equaled about a fifth of Honduran GDP in recent years, declined about 8 percent (around USD 100 million) year-on-year through June, because of the U.S. recession. The de facto government has issued a call to U.S.- resident Hondurans (many of whom apparently support the coup) to increase the amounts they send to their relatives in Honduras if possible. While some may want to do so for patriotic reasons or to help their relatives survive the current crisis, their financial situation may prevent them from doing so.

¶14. (U) Net foreign reserves of the Central Bank were about USD 2.5 billion just before the coup. They had fallen to about USD 2.3 as of July 14. There is insufficient data to determine the primary cause for the decline, although capital flight is a likely candidate. The de facto government may have to impose capital controls if the leakage cannot be contained.

¶15. (SBU) The Zelaya administration maintained a fixed exchange rate against the dollar, a policy begun in the last year of the Maduro administration (2002-2006). The de facto government has announced that it will continue the fixed exchange rate policy. However, it is unlikely that this policy can be maintained for long given eroding competitiveness and declining reserves. Before the political crisis, outside analysts estimated a 5-percent nominal

devaluation would be needed to restore equilibrium.

Impact on Demand

¶16. (SBU) Since October 2008 imports have fallen substantially, indicating a strong decline in domestic demand. Since the coup, banks have reported some withdrawals and also switching of deposits from lempiras to dollars, indicating a possible hoarding of cash, which indicates a possible further drop in demand, possibly leading to a deflationary spiral.

Comment: Can de Facto Government Survive?

¶17. (C) The Honduran economy will continue to suffer from the global recession, aggravated by a cut-off of external aid and the impacts of the political crisis. But as long as trade lanes remain open and the political turmoil does not escalate into civil war, the economy should be able to scrape by. In the first half of the year, reduced exports and remittances were more than offset by reduced imports and lower fuel prices, so that the current account deficit actually shrank. The de facto government may opt to restrict imports (possibly violating CAFTA), impose capital controls and/or devalue the lempira to stem the loss of international reserves. But these issues should be manageable over the next six months.

¶18. (C) Over the longer term, survival without foreign aid will require more drastic measures by the de facto government. The impact of continued constitutional limbo and international isolation on private foreign investment could also have severe and long-lasting impacts. Thus, if the de facto government chooses not to negotiate a solution to the current constitutional crisis that will restore the democratic and constitutional orders and domestic and international legitimacy, it may have to resort to increasingly authoritarian means to counteract the popular

backlash to higher unemployment and austerity measures. End Comment.
LLORENS